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NO. 430

IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

UNITED STATES OF AMERICA, *Petitioner,*

v.

OGILVIE HARDWARE COMPANY, INC.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

BRIEF AMICUS CURIAE.

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BRIEF AS AMICUS CURIAE BY HAWAIIAN CANNERIES COMPANY, LTD., HONOLULU, HAWAII.

PRELIMINARY STATEMENT.

The Hawaiian Canneries Company, Ltd., Honolulu, Hawaii, asks that this brief be considered by the Court in support of the opinion and judgment of the United States Circuit Court of Appeals for the Fifth Circuit in the above entitled cause. Counsel for the petitioner and for the respondent herein have consented to the filing of this brief.

The Hawaiian Canneries Company, Ltd., has a suit pending in the Court of Claims of the United States, No. 47332,

Hawaiian Canneries Company, Ltd., Plaintiff v. *The United States of America, Defendant*, and the facts therein are substantially the same and the questions of law are identical with those in the case at bar.

QUESTION INVOLVED.

Whether the tax relief credit for state or territorial statutorily prohibited dividends granted by Congress to deficit corporations by section 26(c)(3) of the Revenue Act of 1936, as amended by section 501 of the Revenue Act of 1942, is cut down and limited by illustrated example No. 2 used in the report No. 1631 of the Committee on Finance, United States Senate, 77th Congress, Second Session.

ARGUMENT.

I.

The legislative history of Section 501 of the Revenue Act of 1942 discloses that Congress amended Section 26 (c) (3) of the Revenue Act of 1936 in order to grant deficit corporations a credit for state or territorial statutorily prohibited dividends, and to remove the hardships resulting from imposition of the undistributed profits surtax due to failure to allow credit for such dividends under the law prior to amendment.

Section 501 of the Revenue Act of 1942 was enacted by Congress to overcome the hardship on deficit corporations resulting from the decisions of the Board of Tax Appeals, affirmed November 12, 1940 by the Supreme Court of the United States, in the cases of *Helvering* v. *Northwest Steel Rolling Mills*, 311 U.S. 46, 85 L. ed. 29, and *Crane-Johnson Co.* v. *Helvering*, 38 B.T.A. 1355, 311 U.S. 54, 85 L. ed. 35, that section 26(c)(1) of the Revenue Act of 1936 "does not authorize a credit for statutorily prohibited dividends" where the "respondent corporation, because of a previously existing deficit, was prohibited by state law from distributing as dividends its profits earned in 1936". (*Hel-*

vering v. Northwest Steel Rolling Mills, 311 U.S. 46, 48, 49).

The Congressional Hearings and Committee reports on the "Revenue Act of 1942" disclose that Congress added the new paragraph (3) to section 26(c) of the Revenue Act of 1936 to remove the admitted hardship on deficit corporations from the imposition of the undistributed profits tax where such corporations were prohibited by a state or local law from distributing dividends during the existence of a deficit.

Section 501 of the Revenue Act of 1942 clearly shows that the corporation's deficit under section 26(c)(3) of the Revenue Act of 1936, as amended, was determined by the state or territorial law, and not by section 115(h) of the Revenue Act of 1936, which last section provides that a stock dividend shall not be considered a distribution of earnings or profits of any corporation to a distributee. Section 115(h) is merely a codification of the law since *Eisner* v. *Macomber*, 252 U.S. 189. Congress never intended that section 115(h) was to be used to cut down the relief, for deficit corporations from hardship of the undistributed profits tax under section 26(c)(3), as amended.[1]

During the consideration of the Revenue Act of 1942 Congress took up the question of "hardships and inequities" arising out of the revenue acts. (Hearings, House Ways & Means Committee, 77th Congress, Second Session, Revenue Revision of 1942, pp. 87-94). Although the un-

[1] *Cf.* The decision of the Tax Court of the United States in *Arrow-Hart Hegeman Electric Co.* v. *Commissioner*, 7 T. C. No. 158, pp. 10, 11 (promulgated December 19, 1946, and Reviewed by the Court) wherein it was held that subsections (a) and (b) of section 115 of the Revenue Act of 1936 (which provisions limited relief from surtaxes to "the amount of earnings accumulated at the time a dividend was declared and paid and to the extent of the current year's earnings which were distributed") could not be used by the Commissioner to cut down relief granted to taxpayers by Congress (second Revenue Act of 1940, as amended by the *Revenue* Act of 1942) under Section 721 of the Internal Revenue Code from excess profits tax in abnormal cases.

distributed profits tax, imposed by the Revenue Act of 1936, had been repealed by the Revenue Act of 1939, Congress considered under section 501 of the Revenue Act of 1942 a retroactive credit to deficit corporations for statutorily prohibited dividends.

At the conclusion of the hearing on the Revenue Revision of 1942, the House Ways and Means Committee on July 14, 1942, reported out House Bill H.R. 7378, but section 501 thereof did not contain any relief provision to deficit corporations for statutorily prohibited dividends.

Later, during the hearing before the Senate Committee on Finance, 77th Congress, Second Session, on H. R. 7378, a number of taxpayers filed briefs and urged Congress to amend section 501 of the Revenue Act of 1942 to permit retroactive relief from the undistributed profits tax where a state or local law prohibited the payment of dividends. Among those protesting the limited relief granted by section 501 of the House bill was the Paris and Mount Pleasant Railroad of Texas. This Texas railroad company directed the attention of the Senate Finance Committee to a decision (which had just been handed down by the Board of Tax Appeals), in the case of *Paris & Mt. Pleasant Railroad Co.* v. *Commissioner*, 47 B.T.A. 443, which held:

> "• • • there is nothing in this case to take it out of the rule of *Crane Johnson Co.*, 38 B.T.A. 1355; affd., 311 U.S. 54; and *Helvering* v. *Northwest Steel Rolling Mills, Inc.*, 311 U.S. 46. In both cases the corporations had existing deficits and they were prohibited by state statutes from paying dividends except out of surplus. Section 26(c)(1) allows a credit if dividends can not be distributed without violating the terms of a written *contract* executed prior to May 1, 1936, which expressly deals with the payment of dividends. 'The language used in section 26(c)(1) does not authorize a credit for *statutorily* prohibited dividends.' (Italics added.) *Northwest Steel Rolling Mills, Inc., supra.*"

The protest of this Texas Railroad Company concluded with "the hope that Congress will extend the benefits of

section 501 of the pending revenue bill to taxpayers circumstanced as was the Paris and Mt. Pleasant Railroad Co. in 1937". (Senate Finance Comm. Hearings, Vol. 2, pp. 2343-2345.)

Mr. William A. Sutherland, of Sutherland, Tuttle & Brennan, Atlanta, Georgia, also testified before the Senate Finance Committee on August 10, 1942, and asked Congress to include in section 501 a general relief provision for deficit corporations where a state law prohibited the payment of dividends during the time the corporation had a deficit. He testified on this matter as follows:

> "Now, I would not say, as a matter of policy, whether I think it is wise at this time to go back and attempt to relieve against the unreasonable hardships under prior acts. I don't know whether I would ever have thought of recommending that that be done at a time like this.
>
> If, however, the Senate is going back and relieve against one of the obvious hardships under the 1936 act, I certainly think there is another case that is equally entitled to be covered.
>
> What you have done by section 501 is to relieve a corporation from undistributed-profits-tax, when it was in such position that if it had paid out money as a dividend, the distribution would not have been taxable as a dividend, and therefore there would be no dividend paid credit, and the corporation would not be relieved of the undistributed-profits tax.
>
> The original 1936 act relieved from the undistributed profits tax corporations which were forbidden by contracts made prior to May 1, 1936, to pay out money as dividends.
>
> The other obvious injustice which I think should be corrected is this: You did nothing in the original act, and have done nothing here, about those corporations which are prohibited by State law, because they have a deficit, from paying out dividends, and I see no reason in the world why if these two cases—the one that you covered in the 1936 act and the one that you are now covering here by section 501—are going to be covered you should not relieve from the undistributed-

profits tax, in those situations where State law forbids the payment of a dividend.

In Georgia, if a dividend is paid when there is a deficit in the corporation, the directors are liable for double damages to anyone who is harmed.

I understand that the Treasury opposes that provision and says that, if you are going to relieve in such a situation, there are some other situations that are equally entitled to relief.

If that is true, I say they ought to be covered, if you are going into the question at all. The fact that there are other situations is no reason for not relieving this situation, which, it seems to me, is just as obvious as the one covered by section 501."

(Hearings, Senate Finance Comm., 77th Cong., 2nd Sess., on H.R. 7378, vol. 2, pp. 1421-1422).

At the conclusion of the Senate hearing, Senator George of Georgia, Chairman of the Senate Finance Committee, on October 2, 1942 reported out H.R. 7378 with the following Senate amendments to section 501.

It amended section 14(a)(2) of the Revenue Act of 1936 (relating to definition of undistributed net income) by striking out in the House bill (H.R. 7378), " * * * the credit provided in section 26(c), *relating to contracts restricting dividends,* * * * ", and inserting in place thereof, " * * * the credit provided in section 26(c) *relating to restrictions on payment of dividends,* * * * ". The Senate also added the following new paragraph 3 to section 26(c):

"(2) Section 26(c) of the Revenue Act of 1936 (relating to credits of corporations) is amended by amending the heading to read as follows: "(c) RESTRICTIONS ON PAYMENT OF DIVIDENDS.—"; and by amending paragraph (3) to read as follows:

"(3) DEFICIT CORPORATIONS.—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends dur-

ing the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936."

It should be noted that the language of section 26(c)(3), as amended, follows the amendment requested at the Senate Finance Committee hearing.

There is no ambiguity about section 26(c)(3). It means exactly what it says, namely that a credit will be granted to a deficit corporation if there is (1) an existing deficit as of the close of the preceding taxable year recognized by the state law, and (2) if there is a state law in existence prior to May 1, 1936 prohibiting the deficit corporation from paying dividends during the existence of such deficit.

The meaning of the statute is clear, and there is no need to refer to the reports of the Congressional Committees to obtain a proper construction of section 26(c)(3). However, the Committee reports show that Congress intended that the State law should be the guide in determining if the corporation had a deficit in accumulated earnings and profits as of the close of the preceding taxable year. The Committee reports show that Congress was removing the restrictions as held by the Board of Tax Appeals in the *Crane Johnson case*, 38 B.T.A. 1355, 1358, that, "The underlying plan of this surtax is to allow credit only for actual distributions," and to substitute in place thereof *a credit for state statutorily restricted distributions.* The Senate Finance Committee Report No. 1631 on section 501 states (pp. 244-245):

> "This section is the same as in the House bill, except that a new paragraph to section 26(c) has been added, providing for an additional credit in cases of corporations having a deficit in accumulated earnings and profits and prohibited by law from paying dividends, • • •
>
> Section 501 amends section 14(a)(2) of the Revenue Act of 1936 relating to definition of undistributed net income, and section 26 of that act, relating to credits of corporations, and grants relief from the undistrib-

uted-profits tax for taxable years beginning after December 31, 1935, and prior to January 1, 1938, by allowing as an additional credit in computing undistributed net income the portion of the adjusted net income which, in certain instances, could not be distributed as taxable dividend."

* * * * * * * * * *

"Under section 14 of the Revenue Act of 1936 corporations in general were subject to surtax at various rates from 7 to 27 percent of their undistributed net income. *In some instances State law or an order of a public regulatory body prohibited payment of dividends during the existence of a deficit even though the corporation had current earnings and profits which would constitute undistributed net income under the definition thereof in section 14(a)(2). Such corporations were, therefore, subject to undistributed-profits surtax even though they were prohibited by law from paying dividends.* The addition of the new paragraph 3 to subsection (c) of section 26 to provide an additional credit in the amount of the deficit in accumulated earnings and profits as of the close of the preceding taxable year is intended to give relief in certain of these cases." (Italics supplied).

The "certain cases" referred to in the last sentence of the Senate report are those deficit corporation cases where there was a state or territorial law prohibiting the payment of dividends during the existence of a deficit in accumulated earnings and profits as such deficit was defined by the state or territorial law.

There is nothing in the wording of section 501 which denies the full credit to "*a corporation*" which prior to the tax year 1936 had declared a non-taxable stock dividend out of a portion of its accumulated earnings and profits. Under the state law of Louisiana (and the laws of many other states and territories of the United States) a stock dividend changes accumulated earnings and profits into capital. The stock dividend capital is merged with the capital which the corporation (previously or later) acquires by the sale of its

stock, and the payment of a dividend under such circumstances is prohibited by the state or local law just as effectually as if the deficit was otherwise created.

II.

The illustrated example No. 2 in Senate Finance Committee's Report No. 1631 on Section 501 relates only to a tax-free-reorganized corporation case. It does not limit the credit under Section 26 (c) (3), as amended, to a corporation which is not a tax-free-reorganized corporation if that corporation prior to May 1, 1936, has declared stock dividends.

In discussing the application of the deficit credits, it is apparent that the author of illustrated example No. 2 in the Senate Finance Comm. Report No. 1631, p. 246, believed that the credit provided by section 26 (c) (3) did not cover the liabilities of an older corporation which had been assumed by "the X Corporation" under a tax-free reorganization. He apparently assumed that the credit for a deficit corporation under section 26 (c) (3) did not apply to the debts of the older corporation because the Supreme Court in the case of *New Colonial Ice Company* v. *Helvering*, 292 U. S. 435, 78 L. ed. 1348, held that a reorganized corporation is not entitled in determining its taxable income for the succeeding period, to deduct a net loss sustained by the older corporation in the preceding period, under the provisions of section 204 (b) of the Revenue Act of 1921 permitting the deduction of a net loss sustained by any taxpayer from the net income of the taxpayer for the succeeding taxable year.

The author of illustrated example No. 2 also must have had in mind the holdings of this Court that a distinction exists between the type of stock dividend declared by "a corporation" and a stock dividend arising out of a nontaxable reorganization corporation case. See, *United States* v. *Phellis*, 257 U. S. 156, 66 L. ed. 180; *Cullinan* v. *Walker*, 262 U. S. 134, 67 L. ed. 906, and other cases cited in *Helvering* v. *Griffiths*, 318 U. S. 371, 87 L. ed. 843. The distinction

was made in illustrated example No. 2 because a stock dividend declared and distributed under a nontaxable reorganization plan is a dividend of profits of the corporations and is individual income to the stockholders and taxable as such. *Rockefeller* v. *United States*, 257 U. S. 176, 66 L. ed. 186; whereas the stock dividend declared by the *Ogilvie Hardware Company, Inc.*, is the type of stock dividend declared in *Eisner* v. *Macomber, supra*, and it is not income and is not taxable; it is a conversion of accumulated earnings and profits into capital of the corporation.

That the illustrated example No. 2 in the Senate Finance Committee's report No. 1631 referred only to a tax-free-reorganized-corporation is also apparent from the fact that the Senate Finance Committee's attention was directed to a tax-free-reorganized-corporation case then pending before the Board of Tax Appeals. In that case a credit was claimed under section 26(c)(2)—(contracts restricting payment of dividends) for "amount of debt reductions made out of income from properties constituted contract credits." In this reorganized-corporation case the Treasury had followed the decision in the *New Colonial Ice Company case, supra*, and ruled that since the statute dealing with the undistributed profits tax used "the terminology 'the corporation,' the resulting credit would be denied." (Hearings, Senate Finance Comm. Vol. 1, pp. 1306-1308.)

The above illustrated example No. 2 in the Senate Finance Committee report does not apply to the *Ogilvie Hardware Company* case because it is not a tax-free-reorganized corporation. It does not seek a credit under section 26 (c) (3) for any older corporation, and no part of its deficit is due to "a prior capitalization of surplus in the course of a nontaxable reorganization". In the case at bar there is only one corporation which was prevented by a state law from distributing dividends while it had a deficit in accumulated earnings and profits.

The general rule that the statutory provision is not to be limited to the illustrations used in the committee reports

is stated in Mertens', Law of Federal Income Taxation, Vol. 1, sec. 3.29, pp. 116-117:

> "The Finance Committee of the Senate and the Ways and Means Committee of the House have made a practice of explaining in formal reports the purpose of specific provisions of the revenue statutes. These reports are helpful in determining legislative intent. They do not, of course, take the place of the statute, *and the statutory provision is not to be limited to the illustrations used in the committee reports unless it is clearly evident that the illustration was used for that purpose.*" (Italics supplied.)

The petitioner at page 20 of his brief frankly admits that illustrated example No. 2 in the Senate Finance Committee's report refers only to a case of a corporation resulting from a tax-free reorganization. In view of this admission and because it is not clearly shown that Congress intended the illustrated example No. 2 to cut down relief under section 26 (c) (3) to a deficit corporation, which had declared stock dividends prior to May 1, 1936, the Court should hold that this illustration has no application to the case at bar.

The House of Representatives also did not adopt or approve the above discussed Senate Finance Committee illustrated example No. 2 when it accepted the Senate Amendment to section 501 of the Revenue Act of 1942. Its legislative action was directed to the bill, not to the Senate Finance Committee's report. It, therefore, appears that both the House and the Senate granted a credit under section 26 (c) (3) of the Revenue Act of 1936, as amended, to deficit corporations which were prohibited by state or territorial laws from distributing dividends during the existence of a deficit. This is further shown by the Statement of Managers on the Part of the House, in House Conference Report No. 2586, dated October 19, 1942, on H. R. 7378, which states (pp. 71-72):

> "Amendment No. 427 (Sec. 501): This amendment to the Revenue Act of 1936 provides an additional

credit for determining undistributed net income subject to undistributed profits surtax in certain cases of corporations having a deficit in accumulated earnings and profits and prohibited because of such deficit by a *State law* or order of a public regulatory body from distributing dividends. There is no comparable provision in the House bill. The amendment also expands the paragraph prohibiting double credits to contemplate the inclusion of this additional credit. * * * " (Italics supplied.)

III.

The Treasury Regulation is null and void because it conflicts with the statute.

We believe that the contentions of the petitioner at pages 30 to 32, inclusive, of his brief with respect to the unauthorized Treasury regulation are answered by the holdings of this Court in the case of *Manhattan General Equipment Co.* v. *Commissioner of Internal Revenue*, 297 U. S. 129, 134, 80 L. ed. 520, 531. The Court said in that case that a Treasury regulation which conflicts with the statute is void:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. *Lynch* v. *Tilden, Produce Co.* 265 U. S. 315, 320-322, 68 L. ed. 1034-1036, 44 S. Ct. 488; *Miller* v. *United States*, 294 U. S. 435, 439, 440, 79 L. ed. 977, 980, 981, 55 S. Ct. 440, and cases cited. And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable. *International R. Co.* v. *Davidson*, 257 U. S. 506, 514, 66 L. ed. 341, 346, 42 L. ed. 179."

See also the decision of the Tax Court in *Arrow-Hart & Hegeman Electric Company* v. *Commissioner*, 7 T. C. No. 158, p. 7, that an "Example" in the regulations of the Commissioner must carry out the Congressional intent.

The Court accordingly should affirm the opinion and judgment of the United States Circuit Court of Appeals for the Fifth Circuit in the case of *United States* v. *Ogilvie Hardware Company, Inc.*, 155 F. 2d. 577.

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Dated at Washington, D. C.
February 26, 1947.